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HAND-DELIVERED

Mr. Ray T. Williamson
Acting Director
Utilities Division
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85007

Re: Retail Electric Competition Rules Draft - Attorney General Comments

Dear Mr. Williamson:

The Attorney General submits the following comments on the Retail Electric Competition Rules Draft:

Definitions:

R14-2-1601 should be amended to make clearer definitions that distinguish the markets to be deregulated from those that will continue to be regulated. The addition of relevant product market definitions would assist in clarifying that, in the deregulated markets, antitrust law and not regulatory process governs.

While definitions of distribution service and meter reading service are provided, ambiguities remain. The product market definition should identify the following distinct product and service lines: a) retail generation and services; b) wholesale generation and services c) transmission services; d) distribution services; and e) marketing and customer services, including demand management. The new draft makes it clear that a separate definition of metering services should also be added, since encouraging new technology has been demonstrated to be a major goal of deregulation.

A clear delineation of each of these product markets should easily enable the Commission and the stakeholders to distinguish between assets and obligations that fall within the deregulated

generation and retail services product markets and those that fall within other regulated markets.

R14-2-1601(22) defines "OASIS" so that it appears to be a particular brand name. It is anticompetitive for the Commission's rules to specify a particular brand of electronic bulletin board data system. The rule should define a type of desired technical standard, rather than a possibly proprietary brand name that all competitors must then use.

In Rule 14-2-1601(28), the definition of "stranded costs" should be amended to clarify that stranded costs only occur in product markets that have become or are to become competitive markets, and that assets used in producing transmission and distribution products, that will continue to be regulated, are not stranded. This will provide clear limitations on the number and type of costs that can be asserted as stranded, and will reduce the need for costly administrative assessments. Since they are not dedicated to products to be sold in a competitive market, under any theory of recovery, assets dedicated to distribution and transmission of electricity are entitled to zero stranded costs. The rules should also specify that recovery of stranded costs must be limited to historic generation costs. Future costs are not stranded, as they are subject to recovery (or loss) in a competitive environment.

R14-2-1601 (28) The definition of Stranded Costs should state that no asset or obligation used or useful for producing a product other than the deregulated products should be considered as stranded. The retraining and employment costs of change and relocation are also not a stranded cost, but are rather costs all companies in the marketplace will incur, from time to time, as market conditions change.

R14-2-1601 should also contain a definition of geographic market as an area in which a producing firm sells or could sell the identified product. The geographic market for generation services is nationwide and the state of Arizona is a geographic sub-market. No smaller geographic sub-markets are necessary or desirable, specifically not smaller territories defined by regulation. The rules should specify that the relevant geographic market for generation and retail marketing services is statewide. The relevant geographic market for transmission and distribution are statewide.

CC&N:

R14-2-1603 should be completely changed into a licensing procedure and not a CC&N that limits geographic territory and gives the vested monopoly provider a shot at preventing competition against itself by litigating whether the CC&N is in the public interest. Competition is in the public interest, a fact already found by the Commission and incorporated as the premise

for the new rules.

R14-2-1603(B) should delete the geographic area restrictions identified as the dates the Affected Utilities currently serve in its entirety. There is no competitive justification basis for dividing the State into smaller geographic markets, as the Rules' CC&N procedure appears to continue to do. The elimination of CC&N limitations before stranded costs are calculated, and particularly before assets are sold, will eliminate future market uncertainty that will affect values. This will aid in securing the highest possible values for generation assets as they will have the potential to compete in a statewide geographic market.

Qualification to compete through application to the Commission in the form of a license, not a CC&N procedure creates additional market certainty at the outset of competition. No competitor should have to face serving notice on his competitor that he is offering services. (R14-2-1603(D)), and should not have to demonstrate that his coming into the market is in the "public interest" under R14-2-1603(F)(5) and should not have to face "public interest" litigation from an entrenched monopoly provider (or the threat thereof) as a cost of doing business. Elimination of CC&N and its replacement with a uniform, non-discriminatory licensing mechanism would facilitate ease of entry, and will further efficiencies, which will support a faster transition to full competition.

The CC&N rules contain an ambiguity following from R14-2-1603(E). If a provisionally approved company can get approved for only twelve months, are other companies approved forever? The most efficient pro-competitive rule would be a licensing requirement subject to annual renewal and current information update requirements.

Absent a statewide geographic market definition for both generation and retail services the rules continue the anomaly that marketing companies who sell the retail generation services product, will operate statewide and contact users and offer services before knowing whether competitive generation will in fact be available in a given geographic area on a certain date.

Statewide geographic market and the elimination of smaller-scale CC&Ns has the added benefit of avoiding additional inefficiencies costs. These definitions will facilitate Affected Utilities' management in assessing the desirability of restructuring debt and renegotiating long-term obligations (and territorial market restrictions found in agreements) in the context of additional statewide market opportunities available to them as competitors, rather than in the context of an uncertain partially-regulated environment.

The rule as configured lends itself to a statewide license. The information sought R14-2-1603(F) is generally the same as would be required for licensing, except that R14-2-1603(F)(3) and (5) should be eliminated. The Commission should be out of the business of requiring tariffs for competitive generation services to be filed. The market and contracts will dictate the rate for those in competition. The Commission could keep the current rule as to regulated generation (until full competition) and create a separate statewide license, with no filed tariffs rule for those applying to serve customers in competition.

Finally, all of the aspects of R14-2-1603 that appear to give the entrenched monopoly distribution companies an avenue for discrimination should be carefully eliminated. Thus R14-2-1603(F)(3) makes new competition dependent on the UDC for having a service acquisition agreement in place before it can apply for a license (or a CC&N). This places the cart before the horse. This is a reasonable requirement only if there is a corollary rule that the UDC must act within a specified time (30 days, for example, and to be mediated thereafter for no more than another 30 days) to close an application for a service acquisition agreement and must do so in a non-discriminatory manner.

Flash Cut Competition:

R14-2-1604 should permit competition for all high-load customers at once. The selection of the "groups" of customers who are to be available appears to be left to the existing monopoly providers, who have powerful incentives to shield themselves from competition by refusing to make their best customers available to competitive service. Whether a customer meets the large-load criteria should be up to the customer, who can provide its own data to a new competitor, and not to the self-interested monopoly provider.

Residential Phase In Program:

Rule R14-2-1604(C)(3) says that residential customers may choose "other metering options" but that language does not appear to apply to industrial and other non-residential customers. That competition in metering is intended for all customers should be clear throughout the rules.

R14-2-1603(G) residential participation appears dependent on agreement by the Affected Utility. The individual's personal choice should be the only determinant, provided the current provider has been paid.

Metering Services:

R14-2-1605 evidences an ambiguity in the new proposed rules. It appears that the Commission wishes to regulate metering, and also to tie metering to the UDCs. But metering services is a product market that can technologically be entirely separate from ESPs or UDCs or Affected Utilities, just as the purchase of electronic telephonic equipment is no longer tied to a provider of telephone services. Metering technology is the one area where competition is guaranteed to produce positive consumer effects and system-wide efficiencies.

Metering services should not require a CC&N, but could be licensed so that consumer fraud does not result from false claims. The Commission appears to want to promote universal connectivity, and thus could appropriately set industry standards. However there should be no tie to an energy provider required. A company with metering capability will likely want to connect to a company with actual or potential market penetration. That activity, however, should not be the subject of Commission oversight.

Standard Offer:

R14-2-1606 should not require an Affected Utility to make "standard offer" available to "all consumers in a class" until the Commission determines competition has occurred. Rather, standard offer should disappear incrementally (in a phase-in) or completely (at a flash-cut) without further oversight. Any ESP or UDC responsibility to make a certain rate or certain services available to any customer in competition is inconsistent with competition, and places limitations on Affected Utilities' management discretion in light of the changed circumstances competition will bring. Moreover, this standard offer obligation could be construed as a continuing "duty to serve" which could generate additional claims for stranded costs or regulatory assets, thus burdening the entire system with the costs of continued inefficiencies. The entire thrust of this rule should be that there is only a "last-resort" duty after competition comes, and if any affected utility wishes to continue to serve a population, it may choose to do so or not, as its own competitive self-interest dictates. It is already in the Affected Utilities' best interest to make a "standard offer" package available to anyone who wants it.

Further, this rule perpetuates cost-based rate making and rate recovery which is no longer relevant in competitive environments, other than as respects last-resort generation and distribution. No other rates should reflect the "costs of providing the service" whatever that cost is, but should be based on the most cost-efficient delivery of those services in a competitive market, again without a bite at any cost-recovery outlet beyond that price consumers are willing to pay in the competitive market.

R14-2-1606(F) is somewhat confusing. The language may actually encourage long-term contracts when shorter-term contracts make more sense in the current wholesale market. The rule may also be read as part of an ongoing "duty to serve" which could increase stranded costs claims.

Customer Data:

R14-2-1606(G) the rule should state "not including price" regarding the customer data to be released, to prevent price coordination.

Stranded Costs:

R14-2-1607(A) should clarify the phrase "offering a wider scope of services for profit." The rules should specifically prohibit Affected Utilities from mitigating stranded costs by using revenues from unregulated competitive non-core services. Such cross-subsidization creates inefficient distortions in both markets. Further, Affected Utilities currently have market power in the regulated geographic and product markets. Allowing cross-subsidization of non-core activities could promote abuse of market power through unfair access to users as a customer base, curtailing competition in other non-regulated markets.

R14-2-1607 has been construed to permit the award of all or part of the "revenue" lost by virtue of competition, as compared to the "equity" lost. Lost revenue, as the Attorney General has argued repeatedly before the Commission, protects the monopoly incumbents from competition by burdening customers with the costs of inefficiencies. No stranded cost definition or methodology rule can stand that permits a lost-revenues award. Lost revenues should not be possible under a proper pro-competitive set of stranded costs rules.

R14-2-1607(G) should require only one filing of the results of the market-value transactions used, before retail choice begins.

R14-2-1607(D) implies (1) a "wires" charge is an acceptable recovery mechanism for unmitigated stranded costs; (2) that unmitigated stranded costs should only be recovered from customers who leave the Affected Utilities' systems or alternatively, who remain in the Affected Utilities' systems but reduce their energy consumption; (3) that the recovery mechanism for unmitigated stranded costs will be different for each affected utility; and (4) that recovery of unmitigated stranded costs will continue indefinitely. A "wires" charge is not consistent with the move to competition because it distorts future energy consumption, and does not fairly allocate the burden of stranded generation costs between those users who have consumed little electricity

and those who have consumed much more. (Indeed R14-2-1607(F) exempts future self-generators from paying any stranded costs, even though their past demands have contributed to the creation of excess generation capacity.) The Rules should provide that stranded costs must be recovered from all users regardless of which generator, broker or retailer, they choose in a competitive environment, as well as independent of future energy consumption. And, the recovery mechanism should be the same for all Affected Utilities. The Rule should make this clear.

R14-2-1607(G) and (H) should not be necessary since a lost-revenues approach should be disregarded in the rules. Estimates are irrelevant if the equity values are established in the marketplace.

R14-2-1610 should be amended to specifically require that Affected Utilities afford "open access" to their regulated transmission and distribution systems in accordance with FERC rules. If competition is expanded for the generation and retail services sectors of the industry, while transmission and distribution remain regulated, vertically integrated providers have incentives to favor their own customers, generators and retailers with better access. Vertically integrated entities "own" the ability to transmit and distribute efficiently at regulated rates, while everyone else could face delays, interruptions, or greater power losses in the transmission and distribution services which are essential facilities in a competitive generation and marketing environment. Many antitrust concerns arise from the (forward or backward) vertical integration of a utility which bottlenecks an essential facility. Open access rules would remove this potentially anticompetitive barrier to entry and prevent the abuse of transmission or distribution market power. This issue is highly relevant to stranded costs because it allows rapid evaluation of firms who will not be able to misuse distribution market power to their competitive advantage in the deregulated product markets.

For the same reasons, the rules should prohibit collusive undersizing. While antitrust enforcement may prevent collusive undersizing of transmission and distribution capacity and FERC under EPAct has the regulatory authority to order expansion of the transmission grid, the policy of facilitating competition inherent in the Rules should expressly recognize and prohibit this positioning in order to prevent anticompetitive limitations. The Rules' defining the impermissible use of regulated products create additional market certainty for investors valuing "stranded" assets in a competitive marketplace.

Affiliate Rules:

R14-2-1617 should specifically require the severance of UDC functions from ESP

functions. The anticompetitive effects from vertical integration of the generation and distribution companies comes from the ability to control the retail customer and the "wires." The risk to competition is not so much that an Affected Utility will share office space with a metering affiliate, it is that it can leverage its retail position by control of information to customers, control of data about customers, and access to customers. To be effective in preventing abuse of the market power enhanced by vertical integration, the rule should require that Affected Utilities must split UDCs and ESPs into separate accounting entities (at a minimum), and then apply the affiliate conduct limitations set forth in this rule to regulated activity.

R14-2-1617(E) creates a most favored nations pricing mechanism which allows a discount to be given to an affiliate so long as it is given to a non-affiliate. MFNs can be used by a dominant buyer to stabilize price at a higher price than a true market price, driving everyone's price up. This pricing mechanism can allow the self-interested economic incentives of some dominant players to drive price, and may take away certain independent incentives a truly independent affiliate may have to price otherwise. R14-2-1617(E)(7) also may allow public posting of prices which could facilitate price coordination and so should be amended to make retail prices confidential.

Additional Rules Needed:

The rules should state that they do not afford an exemption from antitrust scrutiny of competitive activities in the deregulated markets similar to the language found in A.R.S. §40-286 as amended by H.B. 2663.

Sincerely,

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cc: Docket No. RE-00000C-94-0165 Service List